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ABSTRACT

More college and universities are being subject to audit by the Internal Revenue Service (IRS). When an institution is selected for audit, it will be notified, probably in writing, and contacted by a representative of the IRS, who will make arrangements for a preliminary visit to discuss the procedures to be followed. Prior to the first meeting with the examiner, counsel should be advised and the business office alerted. A single individual should be chosen to act as liaison officer with the IRS. There are three kinds of audits to which the institutions may be subjected: (1) a general audit, (2) payroll audit, or (3) a team audit. In anticipation of an audit, an institution should make a special examination in two areas: (1) unrelated trade or business, and (2) withholding. (Author/KE)

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NACUBO Special Report 75-5

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Internal Revenue Service

PREPARING FOR IRS AUDITS OF COLLEGES AND UNIVERSITIES

This Special Report was prepared for NACUBO by John Holt Myers of the Washington law firm of Williams, Myers and Quiggle. It is intended to assist institutions that are undergoing, or preparing for the possibility of, an Internal Revenue Service audit.

INTRODUCTION

At a dramatically increasing rate, colleges and universities, large and small, are being subjected to audit by the Internal Revenue Service (IRS). This may in part reflect the creation of a new Exempt Organizations Division of the IRS under an Assistant Commissioner for Employee Plans and Exempt Organizations and the establishment of key districts for dealing with problems related to exempt organizations. For the benefit of those institutions which may face such an examination, set forth below are some comments based upon the experience of those institutions which have undergone Internal Revenue Service audits.

GENERAL PROCEDURES

When an institution is selected for audit, it will be notified, probably in writing, and contacted by a representative of the Internal Revenue Service, who will make arrangements for a preliminary visit to discuss the procedures to be followed. Prior to the first meeting with the examiner, counsel should be advised and the business office alerted. It is important to decide at the outset upon a single responsible individual to act as the liaison officer with the Internal Revenue Service with respect to all matters concerning the audit.

At the initial meeting, the IRS examiner should be asked to specify the period to be covered and to outline the manner in which the audit is to be conducted, the procedures which the examiner expects to follow, and the time which the agent and his associates expect to expend in the examination. It would be wise to plan to provide the agent with an office on campus to which all documents and data which he requests can be delivered. The liaison officer should keep a record of all of the data examined by the agent and should be responsible for the preparation and delivery of all copies of documents which he may request. It is desirable to cooperate fully with the examiners, but the delivery of material and documents should be made only upon request. Where issues of privacy, under the Buckley Amendment or general law, are involved, counsel should be consulted. In questionable situations, documents should be delivered only in response to a proper subpoena. Any interviews between the agent, faculty, students and other personnel should be scheduled through the liaison officer. Subject to advice of counsel, a representative of the institution should be present at any interview, and a

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record made for the institution's purposes. In addition to keeping a log of all material provided, the liaison officer should retain a copy of any documents provided at the request of the examiner.

After he has completed his preliminary examination, the agent will probably want to discuss specific problem areas informally with representatives of the institution and indicate those areas where he proposes to make adjustments of one sort or another. It is usually possible at these preliminary conferences to dissuade the examiner from proceeding further in certain areas by providing additional data or legal memoranda concerning the issues involved.

It is important to note that examining agents are bound to carry out the express policy of the Internal Revenue Service with respect to a particular issue, whether or not that policy conflicts with decided cases. One problem faced by colleges and universities is that there can be many issues with respect to which the IRS has not taken any formal policy decision.

So long as the case remains at the District Director's level, either the agent or the institution may request that one or more issues be referred to the National Office of the Internal Revenue Service for technical advice. If this is done, the institution is given an opportunity to state its own version of facts and provide, through counsel, memoranda with respect to the issues of law raised. If, after these procedures are followed, there still remain unresolved problems, the agent will prepare a formal written report, a copy of which is provided to the institution with a notice as to the avenues of appeal. Normally, the institution is required to file a written "Protest" to the agent's findings in the form outlined in the notice. The "Protest" will set forth the institution's version of the facts and provide a memorandum on the legal issues involved.

At the option of the institution, the protest will be referred to reviewers within the District Director's office with an opportunity for a "District" conference. Depending on the kind of issues, there is a further right of appeal to the Appellate Staff of the IRS or to the National Office in Washington. The Appellate Staff and the National Office have considerably more authority than the District Director's office to resolve issues based upon legitimate disputes as to interpretation of the law. If these administrative remedies have been exhausted and there remains a dispute as to the facts or the application of the law, a formal "deficiency" in taxes will be asserted. In the case of most taxes, the institution may continue to refuse to pay the tax and appeal the IRS decision by petitioning to the U.S. Tax Court. From there appeal lies to the Court of Appeals and ultimately the Supreme Court. Otherwise, the institution may pay the tax and seek refund through the District Court or the Court of Claims. From the District Court, there is a right of appeal to the Court of Appeals and the Supreme Court. In the case of the Court of Claims, appeal is taken directly to the Supreme Court.

KINDS OF AUDIT

There are three kinds of audits to which the institutions may be subjected:

(1) *General Audit*——In a routine audit, an examiner will base his examination upon the information return (Form 990) and/or the unrelated trade or business income tax return (Form 990-T) filed by the institution. He may make a routine examination of the minutes of the meetings of the board of trustees and important committees thereof and verify the institution's application for exemption and for a determination that,

as an operating educational institution, it is a "public" charity. Although he will make routine inquiries to determine that the institution has properly withheld income and social security taxes with respect to employees, his principal interest in this area will be the information forms which the institution has filed (Form 1099) with respect to payments to consultants and independent contractors to determine if the payees may, in fact, be employees.

However, most of the efforts of the routine audit probably will be devoted to determining whether or not the institution has unrelated trade or business income which it may not have reported on the Form 990-T [see below]. In addition, he may make inquiries to determine that the institution is not following racially discriminatory policies with respect to the admission of students and the granting of scholarships. [See Revenue Ruling 71-447 and Proposed Revenue Procedure.] He may also examine "problem" areas, for example, to make sure that the prohibition against political or substantial legislative activities is not being violated.

(2) *Payroll Audit*——The Internal Revenue Service has established in each District Director's office a specially trained group of reviewers whose sole responsibility is to determine whether or not employers have properly withheld income and social security (FICA) taxes with respect to employees. Because colleges and universities are usually large employers, they are very likely to be chosen for such an audit. The payroll auditor will be particularly interested in seeking to determine:

(a) Whether individuals treated by the institution as independent contractors are, in fact, employees, and

(b) Whether there are direct or indirect benefits being provided to employees and others which should have been treated as taxable compensation and, therefore, subject to withholding.

Thus, the agent will probably make an in-depth study of the Forms 1099 by which the institution reported payments to independent contractors and consultants to determine whether in fact there was an employer-employee relationship. The examination of untaxed benefits has two facets. The first is a study to determine whether there were bargain elements in facilities and services provided to employees which do not come within the exemptions and exclusions of the statutes and law. The second, and by far the most significant insofar as colleges and universities are concerned, is an examination of the institution's scholarship and fellowship program to determine whether individual payments should be treated as compensatory in nature because they do not come within the exclusionary rules of IRC Section 117.

(3) *Team Audit*——In some circumstances, the audit will be conducted by a team of examiners made up of specialists in general audits and specialists in payroll audits. Such an examination is likely to be made in considerable depth and may call for the presence of auditors on the campus for as much as six months to a year.

If the institution is one chosen by the IRS for the Taxpayer Compliance Monitoring Program (TCMP), it may be asked to respond to additional questions. The responses will be used by the Internal Revenue Service in connection with its own internal procedures as well as to provide data on which to base recommendations for change in the law. Many of these questions relate to the possible effect of an imposition on public charities of the private foundation rules with respect to self-dealing, jeopardy investments, excess business holdings and taxable expenditures (grants for prohibited purposes).

ISSUES

In anticipation of an audit, an institution should make a special examination in two areas:

(1) *Unrelated Trade or Business*——The IRC imposes a tax on the unrelated trade or business income of all exempt institutions, including colleges and universities. Basically, an unrelated trade or business is a trade or business regularly carried on which does not contribute importantly to the carrying out of the institution's exempt purposes other than to provide it with income. The statute provides specific exclusions for "passive" income like dividends, interest, certain rents, income from most gains, as well as an exception, in the case of colleges, for income from an activity carried on primarily for the convenience of the students, faculty, employees and others. There are also special rules with respect to the taxation of unrelated debt-financed income (investment income traceable to borrowed funds) and advertising revenue of exempt publications. The institution's activities should be examined in the light of the statutory provisions and the regulations interpreting them. Special attention should be paid to the utilization of college facilities or equipment for other than educational purposes or by persons outside the college community to make sure that such use comes within the exceptions of the statute.

(2) *Withholding*——The institution should establish procedures for determining whether a payee is an employee or an independent contractor to insure that there is proper withholding with respect to the former.[1] All scholarships and fellowship grants should be carefully examined to determine whether they come within the purview of the specific statutory rules of IRC Section 117 and, therefore, are not subject to withholding.[2] Unfortunately, there are a number of problems in this area because of the myriad and conflicting decisions of the courts. In this connection, special attention is invited to Revenue Ruling 63-250 setting forth the conditions under which grants to research assistants will be treated as fellowships and scholarships. The same rules should apply to teaching assistants. In addition, the institution should be alert to the issues which may be raised with respect to the provision to faculty and others of direct or indirect untaxed benefits which are not specifically excepted from taxation under the Internal Revenue Code.[3]

It should be noted that, as a result of the Freedom of Information Act, there are now available a number of publications of the Internal Revenue Service which may prove useful to an institution preparing for audit. The Internal Revenue Service manual with respect to "Exempt Organizations Audit Procedures" should be particularly instructive in this regard [Internal Revenue Manual 4(11)00]. In special circumstances other sections of the manual can be helpful, such as that setting forth the factors which IRS agents should consider in determining whether an employer-employee relationship exists [Internal Revenue Manual Exhibit 4640-1]. Such documents provide valuable guidelines to the IRS interpretation of the Code beyond the regulations and published rulings.

The following footnotes were added by NACUBO to the preceding analysis by Mr. Myers.

[1]Pages 6 and 7 of this *Special Report* include a reproduction of Treasury Department regulations that define "employee" and "employer."

[2]See "Tax Status of Degree Candidates Fellowships and Scholarships: An Unjustified Change in Internal Revenue Service Policy," *Business Officer*, September 1974, pages 10-11. (Excerpts of a letter from John Holt Myers to D. F. Finn)

[3]It may be appropriate to mention here that tuition remission for dependents of faculty is an issue not unrelated to IRS audits, and that institutions are advised to review carefully their tuition remission practices. Historically, tuition remission has been considered a scholarship. Section 117(a) of the Internal Revenue Code provides that gross income of an individual does not include any amount received as a scholarship at an educational institution or as a fellowship grant. Nevertheless, there have been instances of Internal Revenue Service auditors challenging tuition remission as scholarship grants, advising that it should be treated as compensation, thus requiring withholding of income and social security taxes.

Several of these challenges have been referred to the National Office of the IRS, which subsequently has advised its auditors to close the files without taking any action. IRS is not requiring withholding on present tuition remission grants, but, at the same time, the issue is under consideration, and there are plans to revise the present regulations with respect to Section 117 of the Internal Revenue Code. However, IRS will not attempt to impose retroactive withholding on institutions.

Because of the legislative history of Section 117, it is not clear to what extent the Service will attempt to reverse the long-standing treatment of such grants as nontaxable fellowships and scholarships. In the interim, if such an issue is raised at or in connection with a member college or university, counsel may wish to consider requesting that the issue be referred to the National Office of IRS for technical advice.

NACUBO PRIMARY REPRESENTATIVES WILL BE RECEIVING, DURING JULY, THE YEARLY SPECIAL REPORT WITH "GUIDELINES FOR COMPLETING IRS INFORMATION RETURNS" (FORMS 990, 990-T, 4848, AND 4849).

TREASURY DEPARTMENT

DEFINITIONS OF

"EMPLOYEE" AND "EMPLOYER"

§ 31.3401(c) Statutory provisions; definitions; employee.

SEC. 3401. *Definitions.* • • •

(c) *Employee.* For purposes of this chapter, the term "employee" includes an officer, employee, or elected official of the United States, a State, Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

§ 31.3401(c)-1 Employee.

(a) The term "employee" includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. The term includes officers and employees, whether elected or appointed, of the United States, a State, Territory, Puerto Rico, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

(b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

(c) Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees.

(d) Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case.

(e) If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

(f) All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers, and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.

(g) The term "employee" includes every individual who receives a supplemental unemployment compensation benefit which is treated under paragraph (b)(14) of § 31.3401(a)-1 as if it were wages.

(h) Although an individual may be an employee under this section, his services may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 3401(a).

§ 31.3401(d) Statutory provisions; definitions; employer.

SEC. 3401. *Definitions.* • • •

(d) *Employer.* For purposes of this chapter, the term "employer" means the person for whom an individual performs or

performed any service, of whatever nature, as the employee of such person, except that—

(1) If the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

(2) In the case of a person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, the term "employer" (except for purposes of subsection (a)) means such person.

§ 31.3401(d)-1 Employer.

(a) The term "employer" means any person for whom an individual performs or performed any service, of whatever nature, as the employee of such person.

(b) It is not necessary that the services be continuing at the time the wages are paid in order that the status of employer exist. Thus, for purposes of withholding, a person for whom an individual has performed past services for which he is still receiving wages from such person is an "employer."

(c) An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

(d) The term "employer" embraces not only individuals and organizations engaged in trade or business, but organizations exempt from income tax, such as religious and charitable organizations, educational institutions, clubs, social organizations and societies, as well as the governments of the United States, the States, Territories, Puerto Rico, and the District of Columbia, including their agencies, instrumentalities, and political subdivisions.

(e) The term "employer" also means (except for the purpose of the definition of "wages") any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States (including Puerto Rico as if a part of the United States).

(f) If the person for whom the services are or were performed does not have legal control of the payment of the wages for such services, the term "employer" means (except for the purpose of the definition of "wages") the person having such control. For example, where wages, such as certain types of pensions or retired pay, are paid by a trust and the person for whom the services were performed has no legal control over the payment of such wages, the trust is the "employer."

(g) The term "employer" also means a person making a payment of a supplemental unemployment compensation benefit which is treated under paragraph (b)(14) of § 31.3401(a)-1 as if it were wages. For example, if supplemental unemployment compensation benefits are paid from a trust which was created under the terms of a collective bargaining agreement, the trust shall generally be deemed to be the employer. However, if the person making such payment is acting solely as an agent for another person, the term "employer" shall mean such other person and not the person actually making the payment.

(h) It is a basic purpose to centralize in the employer the responsibility for withholding, returning, and paying the tax, and for furnishing the statements required under section 6051 and § 31.6051-1. The special definitions of the term "employer" in paragraphs (e), (f), and (g) of this section are designed solely to meet special or unusual situations. They are not intended as a departure from the basic purpose.

7 *Publications for More Effective College and University Administration*

College and University Business Administration, Third Edition (1974). This edition, a complete revision of the 1968 manual, includes seven new chapters on financial accounting and reporting. Known as the most authoritative guide to principles of business and financial management in higher education, *CUBA* (1974) represents the involvement and expertise of hundreds of college and university business officers, representatives of business-related associations, and consultants. A basic reference for the business officer, members of governing boards, state budget and finance officers, accountants and auditors, and many others. *$15.*

Administrative Service. Incorporating *College and University Business Administration,* Third Edition, the Service is available in looseleaf binder form for supplementation and revision on a regular basis. The 1975 supplements include "Student Loans," "A System for Accounting for Physical Plant Costs," "A Classification of Accounts for Physical Plant," and others. Basic chapter revisions are planned on an annual basis, with four to be accomplished in 1975. Subscriptions are available at *$20* annually to members (*$15* for renewals) and *$40* annually to nonmembers (*$35* for renewals).

Federal Regulations and the Employment Practices of Colleges and Universities. This subscription service, cosponsored by ten higher education associations, provides timely information on employment matters which are regulated by the federal government. First published in 1974, the service presently covers ten areas of federal law, including OSHA, collective bargaining, employee benefits, federal contract requirements, wage and price controls, sex discrimination, and four chapters devoted to different federal programs for achieving equal employment opportunity. Subscriptions, including three revisions published during 1974-75 and all revisions scheduled for publication during 1975-76, are available at *$12.50.* Renewals will be approximately *$5* annually.

A College Planning Cycle: People, Resources, Process (1975). A successor to *Planning, Budgeting and Accounting: Section II of a College Operating Manual,* this planning guide enables colleges and universities to implement planning and budgeting without consultants. Planning and budgeting are treated as part of one process in the manual, and the procedures utilize the "team" concept. Many sample forms and a flow chart are presented to illustrate the process. *$10.*

Government Contracts and Grants for Research: A Guide for Colleges and Universities (1975). This is a compilation and analysis of clauses that appear in federal agreements. More than 100 different contract clauses are identified, and there is a narrative section on research grants, the relationships between contracts and grants, and sponsored programs of private foundations. This is a valuable reference tool for research administrators and business officers engaged in the process of administering programs sponsored by the federal government. *$10.*

A Student Records Manual: Guidelines for the Administration of College Admissions, Financial Aid, and Registration Programs, a comprehensive manual prepared in 1970 under NACUBO leadership. The manual, which includes a variety of sample forms, tables, and schedules, is a valuable tool for the review of institutional practices and an excellent point of reference for building institutional systems. *$12.*

Risk Management and Insurance: Guidelines for Higher Education, a 156-page manual prepared by John F. Adams, Director of the Georgia State University Center for Insurance Research. The guidelines, published in 1972, include an in-depth analysis of evaluating and treating risk on campus, with specific discussions of property insurance, casualty and liability insurance, insured fringe benefits, and the relationship between higher education and the insurance industry. *$5.*

The above publications are available from the NACUBO national office at One Dupont Circle, Suite 510, Washington, D.C. 20036. Please include a check made payable to NACUBO with any order. If you wish to be billed instead, $1 will be added to the amount of the order to cover the cost of handling.